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Conditions of Proposed 2014 Value Added Tax in Mexico

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Report Highlights:

On September 8, 2013 the Government of President Enrique Peña Nieto announced its plan of fiscal reforms aimed at boosting revenue and improving social development programs. The Value-Added Tax (*Impuesto al Valor Agregado* or IVA, in Spanish) has developed into one of the most contentious political and social issues this year in Mexico. The IVA expands the list of taxable items, alcohol, pet food, a capital gains tax, and much more. Originally, rumors conceived that the proposition had included taxes on certain retail foods and medicine, but they were excluded from the list as the proposal was formally unveiled. The IVA could reduce exports of certain U.S. commodities and processed foods. Critics believe some portions of society could be negatively affected by encumbrances from tax introductions, while others feel the increased revenues could positively affect the obesity crisis and improve social services. As of this writing on October 18, 2013, the Chamber of Deputies voted in favor of a value-added tax, with the bill being sent to the Mexico Senate followed presumably by the executive branch for ratification. If this law passes, the Government of Mexico is set to increase its Gross Domestic Product (GDP) and financial budgets for 2014 by 39 billion pesos, to be used for a variety of societal programs, infrastructure, and food security.

General Information:

In January 2013, the Inter-American Development Bank (IDB) conveyed that the government of Enrique Peña Nieto, in order to raise its GDP by seven percent to improve its economy, should implement certain tax reforms, including a 16 percent exemption tax of certain products and services. According to the World Bank, Mexico's GDP was expected to grow 3.5 percent during 2013 with a recovery in 2014, but recent economic reports estimate a reduced growth of 1.8 percent, coinciding with a reduction in consumer price inflation.

One of the goals of the tax is to reduce dependency on government funding sources from Mexico's state-owned petroleum company, Pemex. According to the Government of Mexico, oil revenues fund approximately one-third of the federal budget and tax revenue is considered the lowest as a percentage of gross domestic product among 34 members of the Organization for Economic Cooperation and Development. Furthermore, President Peña Nieto claims the plan to reduce the tax burden on Pemex allows for opportunities for greater company investment and guarantee public pensions. According to Reuters, the tax burden on state oil monopoly Pemex would drop under 60 percent from the current 79 percent.

Revenues gained from the IVA are designed for many social programs, including public pensions for adults over 65 years old, a social security fund, and food security interventions. President Peña Nieto also promised increased investment in hospitals, roads, airports, science, education, and general infrastructure programs. The proposal, while known since early 2013 but publicly announced September 8, is a 16 percent flat value added tax and lifts many different exemptions for selected demographics. The complex proposal is slated to gain an estimated 39 billion pesos in revenue by placing a tax on a wide variety of items and services, including:

1. Pet food (those who have pets reflected the ability to keep and maintain pets and are therefore able to pay a tax)
2. Chewing gum (not considered a food, rather an added sugar product)
3. Flavored drinks (including certain juices, soda beverages) that contain added sugars
4. Raise the income tax on individuals from 30 to 32 percent, applying to persons with incomes over 500,000 pesos (~\$30,000 US) annually
5. Tax on jewelry and precious metal items
6. Foreign Agencies (such as the FAS-Agricultural Trade Office, authors of this report) will pay an IVA when they host conferences or exhibitions for foreign market development
7. Remove the IVA exemption to foreign passengers using public transports
8. Capital Gains tax of 10 percent for traders in the Mexican Stock Exchange
9. Reduction in the amount of possible tax deductions to an amount of 10 percent of the annual income per individual
10. All businesses must pay the same rate of income taxes and would no longer be classified as a 'small business'
11. Purchased houses valued above 3,500,000 pesos will be taxed
12. Two additional taxes include efforts to reduce greenhouse gas emissions, and discourage the use of pesticides that could damage to health and environment.
13. Residents on the border cities, such as Nuevo Laredo, Juarez, and Tijuana will pay the national

rate of 16 percent, originally having paid a preferential rate of 11 percent.

Additionally, it was reported on October 11, both the ruling PRI (Institutional Revolutionary Party) and PRD (Party of the Democratic Revolution) parties were analyzing an additional value-added tax on video games and “junk food” items. This included certain processed snack foods deemed unhealthy, and beer of predetermined volumes with the possibility of these taxes accumulating an additional 10 billion pesos annually. This was reported to have been included in the October 18 agreement. Furthermore, Peña Nieto’s administration announced an agreement had been reached on a proposed tax on public shows, including sporting events, concerts, and bull fights, which will not be levied a tax in 2014, a possibility for such programs could be open for debate in the future. Such taxes, including an IVA on all purchased housing and rentals, which were initially considered, have also been disregarded, including an IVA on tobacco products.

Overall, the 2014 tax reform has been met with opposition from varying political parties, labor groups, and other civil societies. President Peña Nieto has admitted this plan has not been popular among certain interest groups, as it has attempted to reduce preferential treatment to various social classes. The bill and the work leading to its passage has resulted in protests throughout the capital to demonstrate against these actions, which for months has been occupied already by additional civil society organizations and activists protesting against educational reforms and a restructuring of Mexico’s national oil company. The law was approved by the Chamber of Deputies on October 15, and will be sent to the senate for approval. The law is set to take effect January 1, 2014.

Critics

Initial estimates state the IVA reforms will raise the GDP by 1.4 in 2014, and 2.9 percent by 2018, a significant increase considering current government revenue from taxes is 13.7 percent, well under the 18.4 percent GDP average in Latin America (USA Today). Additionally, According to “*El Economista*” newspaper, Mexico invests approximately 7 percent of the total government budget on programs to fight the obesity epidemic, with hopes to raise that amount with this additional tax. Currently, 70 percent of the Mexican population is considered overweight and 33 percent obese, according to the World Health Organization. The tax on sugared items has been likened to a similar proposal in New York City by Mayor Michael Bloomberg. In fact, according to the New York Times, a 10 million dollar award from Bloomberg Philanthropies is being used to promote anti-obesity interventions, an advertising campaign; financing research at Mexico’s National Institute of Public Health, and lobbying efforts on nutrition labeling and regulation.

However, there are many critics of the proposed laws. In one example, Alejandro Calvillo, director of Consumer Power Mexico states the soda tax will have no impact, and rather a cultural change is required instead, as the tax would not decrease consumption. Additionally, many believe the greatest negative impact will be on the poor, especially in urban areas, where there is little to no access to land and locally produced foods. About 46 percent of the Mexican population, or 53.3 million people, lived in poverty last year, according to the National Council on Social Development Policy. However, Mexico's poverty rate fell 0.6 percent between 2010 and 2012 to 53.3 *million people*, as population growth contributed to the overall rise in poverty, despite decreasing percentages rates and a growing economy.

Other domestic interest groups against the bill included the Mexican Association of Pet Food Producers, who state the tax will reduce purchasing power domestically, and consumers will spend less money on their pets; and with the 13 million animals living in the streets, an additional 500,000 would be added. Animal welfare groups have also signaled their displeasure at this tax.

Impact on U.S. Exports

The IVA reforms could potentially affect exports of certain U.S. processed products and raw commodities. Products considered luxuries in the Mexican diet, such as artisanal cheeses, alcohols, fresh produce, and processed cereals could all be consumed at reduced rates, but this is considered speculation. According to the USDA, in 2011 Mexican households contributed 24.1 percent of annual income to purchasing food. Presumably, the IVA could put pressure on lower to middle-income families, who would spend more on basic foodstuffs, and possibly less on specialty and processed products and other luxuries based on reduced purchasing power. The current atmosphere of both a growing young middle class and the increasing number of impoverished persons without adequate purchasing power, could lead to an unfavorable reduction in trade in U.S. food products. Additionally, current poverty rates place greater expectations of both voluntary and involuntary migration from various regions of Mexico and to the United States.

The new tax reforms will affect U.S. commercial interests. The original flat tax law, or IETU2 (*Impuesto Empresarial a Tasa Unica*), enacted in 2008 will be eliminated. In the garment or *maquila* industry, companies will now be subject to pay the 16 percent rate on imported materials and machinery, where no such tax was required previously. According to Reuters, the reform limits salaries and benefits *maquiladoras* can deduct from income taxes and would place a 10 percent tax on dividends. Additionally, 90 percent of revenues from this sector must be from exports, having been exempted under the previous law. Critics state this would raise operating costs and negatively affect the workers and reduce exports from this sector. Originally, many companies avoided the IVA by assuming an international holding title while producing in Mexico. Therefore, manufacturing companies would import raw, bonded commodities and equipment without paying import taxes or VAT, having the finished products being exported. However, Peña Nieto's IVA terminates these exemptions on temporarily imported goods, with a goal to increase transactions between manufacturers and Mexican holdings and prevent internationally sourcing and imports, mainly from the United States. For many U.S. exporters and distributors, this could be problematic, as normal supply chains could be severed, as the consulting firm Deloitte states:

“The questions that the border industry is asking are, what will we do in the meantime while we find these local providers? It may result in the fact that many of the companies located in the border find the costs too high, and decide that it's not worth looking for national providers.”

The tax reforms could force international companies to restructure, as it would be difficult for certain manufacturers to be classified as an international holding in Mexico. Specific reimbursements have been proposed, including receiving an IVA refund for incurred costs on certain imported products, however, the goal of the Mexican government in this instance is to maintain profits inside the company. Ending these IVA exemptions on the *maquila* industry could negatively impact small companies with weak cash positions. Additionally, many agree the tax reforms in this industry will raise tax receipts for the government in the short term; it does nothing to expand the overall public tax base, which is a more

serious issue.

To conclude, the IVA tax reforms will play an important role for Mexico's economy. It is too early to state whether or not the proposals as stated above will be enacted by the Mexico Senate, and approved by President Peña Nieto, and to what exact effect they will have, both on the Mexican populace and U.S. interests. It is recommended U.S. exporters and distributors pay special attention to the law, once passed, and what it will mean for their company.

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